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## DIRECTORATE OF INTELLIGENCE

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## China's Economic Reforms: Stretching Socialism

Summary

*In the last five years, China's leaders have initiated new economic policies that stretch Marxist orthodoxy and would, if implemented fully, produce profound changes in China's economic management. This economic reform program--controversial and still evolving--has affected nearly all sectors of the economy. Beijing, however, has not developed a coherent strategy for reform and does not plan to have one until after 1985, the end of the current five-year plan. The changes under consideration are similar to those tried in Eastern Europe and the Soviet Union because the motivation for change and the general approach have been similar in all these cases.*

*The key question for China is how far it will go in introducing market forces into its economy. Much will depend on whether Beijing succeeds in carrying out the massive price reform necessary if market forces are to work effectively. We believe that Beijing will continue to experiment with reform, but that economic and political considerations reduce sharply the prospect of a fundamental departure from a centrally managed, planned economy.*

Goals and Background of Reform

The Deng Xiaoping-led government has initiated two types of change in the Chinese economy: **policy readjustment** and **systemic reform**. Beijing's economic policy now focuses on balanced growth to raise living standards rather than on blind pursuit of heavy industry and extensive investment. The systemic reforms aim to decentralize production, management, and investment decisionmaking. The reforms specifically seek to reduce direct central government control of the economy, increase the use of

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market forces and macroeconomic policy tools to allocate resources, enhance the powers of enterprise managers, encourage entrepreneurial skills, and motivate the work force by more closely linking pay to productivity.

As was the case earlier in the Soviet Union and Eastern Europe, the increasing complexity and inefficiency of the economy prompted the Chinese to reassess the Stalinist model that Beijing had adopted practically wholesale from the Soviet Union in the 1950s.<sup>1</sup> Following the disastrous Great Leap Forward (1958-62), the government began to consider reforming China's management system, but discussion of this was cut off by the beginning of the Cultural Revolution in 1966. The death of Mao Zedong in 1976 and the return to power of Deng Xiaoping in late 1978 allowed reconsideration of economic reform. Most Chinese officials agree on the need for change, but there has been considerable debate on how to go about it.

The debate can be divided into two periods. During 1979 and 1980, the government encouraged a free discussion during which many economists argued for an approximately equal mix of planning and the market. Since late 1980, the government has served notice that planning should take a preeminent position and that the market should be permitted only in areas that do not conflict with plan targets. Ideological objections were partly responsible for the change, but Beijing also fears that greater reliance on market forces would leave it with too little control over the economy.

#### Implementation Measures and Problems

Beijing admits that it has not developed a comprehensive, integrated reform strategy, nor does it plan to have one before the current five-year plan ends in 1985. Since late 1978, Beijing has instead instituted reforms piecemeal in what it characterizes as "groping" for solutions to specific problems.

The most sweeping and successful changes thus far have come in agriculture, where over three-quarters of the land has been "de-collectivized" and divided among peasant households. The peasants do not own the land but have effective control over its use, and they are free to market and retain the income of production above the amount contracted for by the government.

In industry, enterprises that formerly remitted all but a small share of their profits to the government now retain a significantly larger share, which they may use to pay bonuses or invest in new facilities. Industrial enterprises also now have

1. The Stalinist model features strong central planning and rapid development of the industrial base at the expense of immediate improvements in living standards.

greater authority to make production and marketing decisions. The government, in addition, has formed several large industrial corporations or trusts, such as the China State Shipbuilding Corporation, which have a purely economic management role, unlike the ministries which also carry out political and administrative functions.

In finance, the consolidated central-provincial budget has been revised to give provincial governments greater discretion in spending local revenues. In commerce, free markets reappeared in cities and the countryside with official sanction and enterprises were permitted to sell some of their product outside the government-run commercial system. In the credit system, banks have been given more power to extend loans for fixed and working capital.

In foreign trade, reforms have given Chinese managers greater freedom to make deals with their foreign counterparts. China has also set up four Special Economic Zones (SEZs) to attract foreign investment. In the SEZs, China has adopted economic policies whose permissiveness and similarities to capitalist practices are unique in China. To minimize the impact of the SEZs on Chinese society, they are cordoned off from the rest of the country, and we believe that Beijing will maintain their isolation.

The government has even given its blessings to some very limited forms of private enterprise, in part to help reduce China's high unemployment. The number of individuals engaged in privately owned production or service activity--small restaurants and appliance repair, for example--has increased over the past four years but is still only 1-to-2 percent of the nonagricultural labor force. Private ownership of capital, however, continues to be strictly controlled, and we do not expect these controls to be eased.

The government has exhibited caution by experimenting before instituting these changes. Nevertheless, problems have been numerous when the reforms have been implemented wholesale.

- Because the reforms have been piecemeal, a **lack of coordination** between reformed and unreformed elements of the system has hindered rather than helped economic performance.
- **Entrenched interest groups** continue to harbor strong objections to the general direction of reform. Opposition is coming from:
  - government ministries that lose power when decisionmaking is decentralized;
  - poor managers who lack the ability to compete in a performance-based assessment system;
  - less able workers and peasants who benefited from the previous egalitarian system;

- workers assigned to low-profit or money-losing enterprises that may be forced out of production.
- Party fundamentalists also object to the direction of systemic reforms on **ideological grounds**. The true extent of these concerns is difficult to gauge because the entrenched interest groups often hide behind ideological objections.
- China's **price system**, which does not reflect relative scarcities in the economy, is giving managers incorrect signals. Because reforms have given many enterprises control over production decisions and because enterprise performance is judged on the basis of profits generated, managers prefer to produce overpriced goods. The resultant excess supply has filled state warehouses with goods for which there are no buyers. The government realizes that China's price structure must be overhauled if the reforms are to work effectively. Nevertheless, because this would mean significant price increases for necessities, the government has decided to delay major price reform for the present.

The changes to date have reduced direct central control over the economy but Beijing, in our view, has not developed the macroeconomic policy tools needed to deal with unwanted side effects. For instance, profits retained by enterprises and localities have reduced central revenues, and local investment has greatly exceeded the national plan. As a result, high priority national projects have gone begging, while local governments fund less efficient ones.

#### Comparisons with Eastern Europe and the Soviet Union

The Soviet Union and the East European countries have all experimented with systemic reforms similar to those in China today. For a brief period in the 1920s, Lenin instituted the "New Economic Policy" (NEP), an acknowledged temporary expedient addressing problems of an economy emerging from the disruptions of World War I and the Bolshevik revolution. The NEP employed a certain measure of free competition and material incentives, and encouraged foreign participation in the country's development. However, the NEP was short-lived and died with the ascension of Stalin in 1928.

In the mid 1960s, following the death of Stalin, the USSR again began experimenting with systemic reforms. These later reforms in the Soviet Union and in Eastern Europe are--unlike the NEP--particularly relevant to any discussion of Chinese reforms because all have included serious experimentation with alternatives to the Stalinist model.

The common motivation for change has been a desire to raise economic efficiency, and the proposed solutions have been generally similar. The Chinese have yet to settle on the

ultimate nature of their overall reforms. We believe they are more inclined toward policies used by the Hungarians, Yugoslavs, and Czechs, which have attempted to introduce greater flexibility into the economy, rather than the more rigid Soviet approach. China's task if anything is more difficult, as Beijing is taking on the monumental tasks of reorganizing the government and purging the Party at the same time.

Although problems of implementation and resistance to reforms in China have been comparable to those in East Europe, there are some noteworthy differences. Unlike China, most of the East European countries have been constrained in their actions by threats of Soviet interference. A second difference is that while China is largely insulated from the international economy, just the opposite is true for East European countries. Finally, China's geographical expanse and immense population may mean that the East European experience is only partially transferable.

Recent events suggest that China may be scaling back its earlier reform plans, especially in industry. The systemic reform programs in Eastern Europe and the Soviet Union all have had to retreat from their original models. For example, Hungary, the only country in Eastern Europe to decentralize investment decisions to enterprises, found that it had to pull back from this experiment when investment rose to unacceptable levels.

#### Prospects for Success

The most immediate threat to economic reform comes from what Premier Zhao Ziyang has characterized as "out of control" local investment spending, which is squeezing out infrastructure projects Beijing regards as key to modernization. In essence, systemic reforms are producing results in serious conflict with economic policy goals. To combat this problem, the government has turned to command-style controls on investment, but we believe these may be insufficient. If they do not work, the government will be forced to retreat from systemic reforms, at least temporarily, and recentralize some of the devolved authority.

We see two other factors that make us pessimistic about the reform program over the longer run. Beijing has yet to show that it can tackle the hard issue of price reform or that it is willing to live with the natural consequences of reform--local economic decisions of which it disapproves. To Beijing's mind, the reforms are working properly when localities make the decisions it would have made.

Perhaps more important, economic reform entails a devolution of political power as well. Some in the leadership warn that weakening Beijing's control over the economy means less control over social and political policy too, and they also voice concern

about the growth of "bourgeois influences" in Chinese society. We believe that if the reform leaders come to share these concerns, they will not hesitate to scrap widespread systemic reform.

For the present, we believe the government will continue to espouse a long-term commitment to economic reforms. Beijing will continue to seek ways to use market forces in the economy, primarily to raise efficiency, but economic and political constraints will preclude Beijing's adopting an economic system that departs fundamentally from a centrally managed, socialist, planned economy.



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